C.D. Howe Institute

Fiscal Policy Monitor

No. 3, November 1989 ISSN 0843-641X

The Other Shoe

The GST: Stage Two of Tax Reform

by

Robert D. Brown

Introduction

Canadians have just gone through a major and rather difficult overhaul of the income tax system, but must now look ahead to radical revisions to their sales taxes. The 1987 revisions in corporate and personal income taxes — widely if somewhat misleadingly called "tax reform" — represented a significant but far from revolutionary change in Canada's tax structure. The entire package of changes introduced from 1985 through 1988 achieved a generally more neutral income tax system, although one still containing important incentives. Tax reform also resulted in lower tax rates, even though these lower rates have already been eroded by subsequent federal and provincial tax increases.

While these changes are widely perceived as a domestic event, tax reform in Canada reflected — obliquely and imperfectly — trends evident in other countries toward less market-directing tax structures and toward a broader and more neutral tax base with substantially lower rates.

Another trend reflected in developments in some, but not all countries, is a higher emphasis on taxes on consumption rather than on income. It has been argued in various reports, such as those of the Macdonald Commission in Canada and the Meade Committee in the United Kingdom,[1] that the tax burden should be based more on what people take out of society (in the sense of what they consume) and less on what they contribute, which, in part, can be measured by their income. In economic terms, taxing income drives a wedge between saving and consumption, because both the income flow out of which capital investment comes and the profits from that capital investment are subject to tax. It can be argued, therefore, that even a broadly based income tax distorts economic choice away from investment and in favor of current spend-

90-01017/

ing, and that a tax system based more on consumption, and less on earnings, would have more positive economic results. A trend toward consumption taxation is reflected in the heavy reliance on value-added taxes in Europe and elsewhere.

In Canada, where tax reform is not an event but a process, a hot debate is now under way on major structural changes to the federal sales tax (FST) system, changes that may have more important effects on the distribution of tax burdens and on the efficiency of the Canadian economy than have the recent income tax reforms.

Why Replace the Federal Sales Tax?

From the viewpoint of international competitiveness, the most adverse part of the Canadian tax system has not been the income tax, but the predisposition for taxes that increase the cost of doing business in this country. The most devastating of these taxes is the present FST — the federal manufacturers' sales tax — a single-stage tax levied, notionally, at the manufacturer to wholesaler level, at a present general rate of 13 1/2 percent (increased from 12 percent in the 1989 federal budget).

Study after study over the past 30 years has detailed the major deficiencies of the FST, a tax relic from the distant past when such single-stage sales taxes at other than the retail level were in fashion. But Canada is now virtually the only country in the world to maintain this sort of tax, which is perverse in the extreme in its economic effects.[2]

Because the tax is imposed only on a limited range of goods — equal to about one-third of consumer spending — and because it represents widely different proportions of the final selling price of the goods to which it does apply, it distorts consumer demand. Because it is levied on a price for domestically produced goods — which tends to include distribution and marketing costs — while imported goods are taxed on the "duty paid" value at the border — which excludes such costs — it imposes a higher tax burden on Canadian-produced goods than on imports. Because a very large part — almost one-half — of the burden of the tax falls on businesses, not on consumers, the FST, along with equally damaging provincial retail sales taxes, hurts the competitiveness of Canadian industry. The defects of the present sales tax structure have been amply catalogued and identified, and its perseverance over so many years is reflective of the only real advantage the tax has (and that only to politicians) — that it is virtually invisible to consumers.

The FST, in recent years, has developed a major flaw in addition to those enumerated above — namely, that its base has been shrinking. In addition to the federal government's predilection for granting exemptions, Canadian producers discovered, through court decisions, that they could lessen their tax burden by setting up new corporate structures under which they would sell their production at little more than bare manufacturing costs to an affiliated firm, with the tax being paid at this level. The affiliate would then undertake the marketing and distribution functions, selling the goods to retailers and others at higher prices. Such tax-reduction plans, along with other technical defects in an antiquated legislation last structurally overhauled in the 1920s, have already begun to erode government revenues seriously. Despite numerous attempts at band-aid revisions, the FST is clearly in a terminal stage of illness, and it is to the credit of Finance Minister Wilson that he has brought forward concrete proposals for its total replacement.

A Value-Added Tax for Canada

The concept of a broadly based goods and services tax is one that falls strangely on Canadian ears, but it is in fact an example of the value-added form of taxation that more and more countries — 48 at last count — have adopted over the past 40 years. In virtually all

countries, it is the tax of choice to replace antiquated single-stage producers' sales taxes and cascading turnover taxes initiated in Europe in the first quarter of the century.

The basic mechanics of a value-added tax (VAT) are simple, even though there continue to be some fundamental misunderstandings about the nature of the tax. Under a classic value-added tax system, tax at a standard rate is imposed on every sale of goods and services in the economy. However, every business can claim as a credit against its VAT liability on its sales the amount of VAT that it paid on its inputs — its purchases of goods and services whose costs are reflected in its taxable sales. This means that each business must remit to the government only the net difference between the tax on its sales, and the tax on its purchases. This net tax is, in simple cases, equal to the standard rate of tax applied to the "value added" of the business, taking value added as the amount added to production through the application of labor and capital.

In concept, the total VAT collected from particular goods and services that consumers purchase will be equal to the standard rate of tax applied to the ultimate consumer selling price. This tax, in effect, will have been paid in installments by all of the producers of goods and services incorporated in the final product, with each one remitting to the government the tax due on its value added. In fact, the economic effects of a VAT are somewhat similar to a retail sales tax, at the same rate, applied to the final purchases of consumers.

A great deal of nonsense has been written around value-added taxes. It is alleged, for example, that the tax falls on labor; that the tax discriminates against those who add a great deal of value to products as opposed to those, as in distribution, who do not; and, most importantly, that the tax is some sort of money machine that can painlessly solve the government's revenue needs. Employing a VAT can help governments to obtain a greater portion of their taxes in the form of economically efficient consumption taxes as opposed to effort-dampening income taxes. However, while there are important arguments in favor of consumption taxes, the revenue-raising abilities of a VAT are really similar to any broadly based consumption tax.

What Is the Magic in a VAT?

If the VAT is largely equivalent to a retail sales tax, why should Canadians contemplate adopting a VAT that requires them to pay this tax, in installments, throughout the production process and, therefore, involves all businesses in the tax calculation game?

- A VAT system leaves a self-policing paperwork trail throughout the economy as each business generally insists on receiving "VAT invoices" confirming the VAT paid on its purchase of goods and services so that it can claim credit for such taxes against the taxes due on its output. Further, if a business illegally "opts out" of the tax system, the revenue lost to the government may only be the tax on its margins and not the entire tax on the goods or services in question. In countries such as Canada, with reasonable business accounting systems and records, this advantage of a VAT is probably of only modest significance, but it is still an advantage.
- The VAT mechanism ensures that the total tax paid on sales to consumers is at a uniform percentage, thereby avoiding distortions of consumer choice and the "doubling up" of tax burden that can damage competitiveness. Under a VAT system, each business obtains full credit for all of the tax paid on its inputs — purchases not only of goods that form part of the physical product being sold, but also of all other items that enter into business costs. For example, the producer of automobiles would be relieved of tax not only on its purchases of steel and rubber, but also on its buildings, computers, transportation, advertising, and what have you, right down to the pencil used in the accounting department to figure out the VAT itself. And all of the suppliers to the

Box 1

The Terminology

While the GST, as a value-added tax, is an elegantly simple concept, its unique refund feature and the terminology used to describe key aspects of the system can lead to confusion. The key items are as follows:

Input: a purchase of goods or services by a business.

Input tax: the GST paid on the purchase of goods or services by a business and relating to its business.

Input tax credit: the GST paid on the purchase of goods or services and refundable to the purchaser; only credits relating to taxable or zero-rated businesses are available for credit; input tax relating to an "exempt" business — for example, most financial institutions — is not refundable.

Supply: a sale or other transfer of goods or services; supply is very broadly defined, and includes some rents, royalties, and management fees, as well as most other services.

Taxable supply: a supply for which the supplier is required to collect the 9 percent GST.

Tax-exempt supply: a supply for which the supplier is not required to collect tax, but is not eligible to recover input taxes for inputs related to the exempt supply.

Zero-rated supply: a supply for which the supplier is not required to collect tax, but is eligible to recover input taxes for inputs related to the zero-rated supply (also referred to as "tax-free" supply)

auto manufacturer similarly would avoid the burden of tax on all of their business inputs, thus enabling them to reduce their prices to the car producer.

Under a retail sales tax, it would be possible, in theory, to provide an equivalent exemption for goods and services purchased by producers for incorporation into their cost of sales. But it is both administratively difficult and politically awkward to make such exemptions effective. Under a retail sales tax regime, it would be difficult for each vendor to determine whether the purchaser was a business that was going to use a product in the production of goods and services or a simple consumer, without an extraordinary trail of certificates and paperwork costly to administer and difficult to police. And it would be politically painful to have a system that called on consumers to pay tax, for example, on their purchases of toilet paper, but allowed manufacturers to buy it tax free for use in factory or office washrooms.

The real magic of a VAT, therefore, rests on the fact that it is, as a practical matter, the only type of broadly based tax that can avoid the doubling-up effect of taxes on business inputs, an effect that inevitably results in different effective burdens on different goods and services, and in building tax elements into business costs in such a way as to make domestic producers less competitive against foreign producers operating under more favorable regimes. The VAT is virtually the only efficient mechanism that allows a country to rebate sales tax totally on its exports. According to the international rules of the road established under the General Agreement on Tariffs and Trade, any other method by which a country tries to rebate indirect taxes on its exports (or impose offsetting taxes on its imports) is likely to prove objectionable: the use of a VAT, with a total tax exemption for exports, is, however, well established as legitimate. Indeed, all the countries of the European Community adopted VATs, in part, to secure this international trade advantage.

Administrative and technical drawbacks are also obstacles to another alternative to a VAT not widely discussed in Canada: a pure consumption tax, levied annually on individuals at, presumably, progressive rates. Every taxpayer would report total income, deduct from this net saving (or add to it net dissaving), and

Box 2

Summary of Goods and Services Tax Categories

	Sales (Supplies) Subject to GST?	*Tax on Inputs Refunded?*
Taxable	yes	yes
Exempt	no	no
Zero-rated (tax-free)	no	yes

Thus, an organization that makes only taxable supplies (sales) is required to collect the 9 percent tax on all of its supplies and can secure an input tax credit for all of its taxable inputs (purchases of taxable goods and services). Many larger and medium-sized businesses will fall into this category.

An organization that makes only tax-exempt supplies need not collect the GST on its supplies, but may not recover any input taxes. Some very small businesses will fall into this category, as will many financial institutions.

An organization that makes only zero-rated supplies will not be required to collect any tax on its supplies, but can secure a full recovery of its input taxes. Businesses that produce only for the export market and producers of home-prepared food products are examples of zero-rated suppliers.

calculate tax on the balance. The concept seems far simpler than collecting tax on every sale and, in theory, gives a fairer and more economically efficient result. However, the implementation of such a tax involves formidable administrative and technical obstacles, and this type of tax has not been used in a pure form. Canada's income tax system might be moved toward a consumption tax by allowing an increased deduction for saving.[3]

The Goods and Services Tax

The goods and services tax (GST) unveiled last August and proposed for adoption on January 1, 1991, is to be along the lines of the classic or European-style VAT. (See Boxes 1, 2, and 3 for summaries of the terminology and mechanics of the tax.) It is to be levied at a general rate of 9 percent on all sales of goods and services in Canada with only limited exceptions, but with full credit for the tax paid on all supply inputs, including the tax payable on capital goods. Like all taxes, the actual administration of the GST, in a complex world, is bound to be convoluted and Ottawa has not failed to make it even more complicated by adopting some important exemptions and by proposing special treatment in particular areas.

The suggested 9 percent rate for the GST is clearly a disappointment. Earlier discussions, going back to 1985, had contemplated a 5 percent rate. In a White Paper released in 1986,[4] the federal government used an 8 percent rate as an illustration. It also supposed that such a tax would raise not only enough revenue to replace the FST, but also to bring down tax rates for middle-income Canadians, provide a "generous" refundable credit for lower-income Canadians to ease the distributional effects of the GST, and eliminate personal and corporate income surtaxes. The proposed 9 percent rate for the GST is, however, intended only to replace the revenues from the FST (the FST rate having jumped from 12 percent to 13 1/2 percent in the interim), as well as to cover the cost of expanded low income credits and a meager 1 percent income tax rate reduction only for the middle bracket. Any thought of eliminating the personal and corporate surtaxes has receded into the indefinite future of balanced budgets.

Pricing: The Issue of Visibility

While it had been earlier supposed that the GST would be added on separately to the price of goods at the retail level, this supposition

Box 3

How the Goods and Services Tax Will Work: An Illustration of the GST for a Chair

	Purchase			*Sale*			
	Price paid	*GST (a)*	*Total*	*Price charged*	*GST (b)*	*Total*	*Paid to Gov't. (b) – (a)*
Forester (log)	$0.00	$0.00	$0.00	$10.00	$0.90	$10.90	$0.90
Mill (lumber)	10.00	0.90	10.90	40.00	3.60	43.60	2.70
Manufacturer (chair)	40.00	3.60	43.60	60.00	5.40	65.40	1.80
Wholesaler	60.00	5.40	65.40	80.00	7.20	87.20	1.80
Retailer	80.00	7.20	87.20	100.00	9.00	109.00	1.80
Consumer	100.00	9.00	109.00	—	—	—	—
Total tax							*$9.00*

This example is, of course, oversimplified. The refund of the tax on purchases (a), as well as the refund of the tax paid on any other business inputs, is available immediately following the purchase. Tax payable on the sale (b) is due on actual sale. Note that a taxable business obtains a tax refund (input credit) on the tax on all of its business purchases of goods and services, not just on the materials incorporated into its products.

vanished with the abandonment of the proposed "national" sales tax. Originally, the federal government had hoped to convince the provinces to join with it in imposing a broadly based national sales tax that would replace both the FST and the retail sales taxes levied by all provinces except Alberta.

The adoption of such a national sales tax would have provided enormous advantages. It would have meant the rationalization of not only the present FST but also the almost equally perverse provincial retail sales taxes, which tend to drive up business costs and to distribute their burden with an uneven hand over consumer spending. In addition, the replacement of provincial retail sales taxes and the FST with a single tax would have greatly simplified the administration of the tax, especially for retailers, and would have enabled the combined rate of tax to be added openly to posted prices. However, and not unexpectedly given the history of federal-provincial cooperation, the provinces apparently were unwilling to commit themselves to a politically risky rationalized system: they feared some loss of provincial autonomy and flexibility, as well having a visible tax of perhaps 15 to 18 percent at the retail level for which they would have to share the blame.[5]

The fact that in nine provinces the GST will be levied along with a retail sales tax on consumer purchases, but with a different list of exemptions, makes it impractical for retailers universally to show tax-excluded prices, and then add both the GST and the provincial retail sales tax as appropriate to each item in separate calculations. The nation's cash registers, to say nothing of the temper of store clerks, are simply not equal to this task. The likely result is that while the GST will be shown separately on business purchases and sales, at least some retail prices will be shown as including the 9 percent GST — that is, the GST will be 8.26 percent of the tax-included retail price — with provincial retail sales taxes added on where applicable. A major opportunity to make taxes more visible to Canadians will have been partially lost.

Box 4

The Goods and Services Tax: Exemptions and Zero-Rated Supplies

	Tax Exempt (sales exempt, but taxable on inputs)	*Zero-Rated* (sales exempt, and no tax on inputs)
Conceptual		
Exports		X
Interest, dividends, taxes, wages		X
Practical/social		
Residential rents	X	
Very small business	X	
Charities (most)	X	
Financial services	X	
Used housing	X	
Legal aid	X	
Prescriptions		X
Health services	X	
Political/social		
Basic food		X
Day care	X	

Exceptions to the GST

The new GST will contain some important exceptions, but before discussing these it is necessary to distinguish between a relatively small list of items that will be truly "tax free" or zero rated — the term frequently used in Europe — and a broader list that will be "tax exempt". In the case of zero-rated goods, not only is the sale of the good or service free of the GST, but the vendor is still entitled to a credit for all the tax on his inputs. This means that there is no net tax whatsoever on final sales of such items. In the case of goods and services that are merely "tax exempt", no tax will be imposed on the selling price of the items, but there will also be no rebate of any tax on the purchases of goods and services paid by the vendor. Accordingly, a vendor of "exempt" goods and services will still have included in his costs the tax imposed on inputs and there will, therefore, be some element of tax in his selling price. (A summary of the principal exempt and zero-rated items and suppliers is provided in Box 4.)

Tax-Free Goods

The big issue here was whether or not food should a be zero-rated good. Despite excellent arguments that food should be taxed — the rich eat as well as the poor — the government succumbed early on in the process and announced that "basic groceries" would be tax free. Even groups such as the Consumers' Association of Canada ultimately recognized that this treatment of food did the poor no favor: imposing the tax on food would make the tax much more uniform in its application, and would have permitted the government to provide more generous low-income credits that could readily have left those at the bottom of the income scale better off than they would be with zero-rated foodstuffs.

Only "basic groceries" — foods to be consumed off-premises, except for designated items such as candy, soft drinks, and snack foods — will be tax free. Most prepared meals, takeout foods, and "junk food" items will be subject to tax. The result is unlikely to lack confusion or market distortion.

Further, food is the one tax-free item that enormously complicates the collection of tax. A huge number of retail outlets, including many small businesses, sell both basic foodstuffs as well as other items that will be subject to the GST. Many retailers have been driven to exasperation and even rage at the thought of having to keep track of federally taxable and zero-rated sales at the cash register, along with provincially taxable and exempt sales (on a different basis).

Other tax-free goods include prescription drugs, certain medical devices, and a number of government purchases. The most important item in the tax-free list, however, will be exports: no goods and services sold abroad will be taxed, and the producer will still be eligible for input credits; thus, for the first time, such items will be completely free of federal sales taxes. It has been estimated that this could result in a drop in the cost of exported goods of as much as 2 percent, thus increasing Canadian competitiveness.

Tax-Exempt Goods

The list of tax-exempt goods is longer, and includes residential rents, used housing, most health services, legal aid services, most education, and financial intermediary services.

Residential rentals and the sale of used residential dwellings (including land) will be exempt, but equally there will be no rebate of the GST paid on inputs. The GST will, however, apply to the sale or rental of commercial and industrial real estate and to the sale of new dwellings, meaning that vendors will be allowed full rebate of taxes on their inputs.

Most medical, dental, and other health services will be exempt from the GST, but practitioners will remain subject to the GST on their purchases. There will also be a broad group of exemptions or partial rebates in the "MUSH" area — municipalities, universities, schools, and hospitals — where, basically, only "commercial" services such as cafeterias and book stores will be subject to the GST on sales, with all other services being exempt.

At first, the government proposed an ill-conceived scheme for the taxation of financial institutions, under which tax would be levied on net financial margins. In concept, it is arguable that such margins represent a fee for the services of such entities. But whatever its intellectual underpinnings, the proposed tax was fatally flawed in that it would simply have added to the costs of financial institutions and would not have been specifically charged through to customers, to be creditable in the case of business purchasers of such "services". The proposed levy, therefore, was nothing more than a tax on the margins of financial institutions, levied in addition to regular income taxes and a range of capital taxes to which they are already subject. The government wisely dropped this proposal, with the result that financial institutions will only be liable to charge the GST on certain specific services, such as the rental of safety deposit boxes or specific service fees to clients. However, the fact that they will be subject to the GST on an expanded range of inputs, including rent, will result in a significant cost increase to the financial sector.

Here and in other areas where entities provide partially taxable and partially exempt services, it will be necessary for them to allocate the tax paid on their inputs between the taxable and exempt supplies: only the tax on inputs deemed to be allocated to the provision of taxable items will be refundable, while that deemed applicable to exempt sales will not. In the United Kingdom and elsewhere, the difficulties of allocating input credits between taxable and exempt sales has proven to be one of the most troublesome aspects of a VAT, and this provides excellent reasons why exemptions should be kept to as narrow a range as possible.

Problems, Problems, Problems...

The review of the GST Technical Paper (released in August) and the draft GST legislation (released in October) inevitably has led to the identification of some areas of particular concern, among which are the following:

- The sale of new residential dwellings will be subject to the GST, but the vendors will be able to obtain a rebate of the GST on its components. Because a 9 percent tax on new dwellings, even with the elimination of the FST on building supplies and materials, would represent a significant price increase, the government plans to provide relief, through subsidies, for new home purchasers that will offset the tax hike — but only on modestly priced homes, and only away from super-heated real estate markets such as Toronto.
- The limited rebate of the GST on lower-priced (up to $400,000) new housing will result in somewhat different effects in different areas, due to variations in housing prices. In addition, the different tax treatment of major renovations (taxable on the value of the entire unit) and mere repairs (taxable only on the repair value) is bound to lead to endless problems. A more sensible approach might be to exclude land from the tax base for all new housing.
- The GST will apply to all sales after December 31, 1990, and this will mean a "doubling up" of tax in respect of goods for which the existing FST has already been paid. The FST content of all business inventories at December 31, 1990, therefore, will be refunded so as to prevent such double taxing. This will involve a short-term negative blip in federal net revenues. However, there will be no credit for sales tax paid on capital assets acquired before 1991.
- The transitional rules will create some incentives to delay or advance purchases, with possible adverse economic effects. For example, business purchases or leases of computers, distribution and office equipment, and certain other items are likely to slow down dramatically in 1990, because those items are still subject to the nonrefundable FST; after 1990, however, they will be liable to the GST, which will be fully rebated. Some method of "feathering in" these shifts would be worth consideration.
- The tax treatment of certain purchases of universities, health organizations, and governments may also benefit from review. It is important to avoid imposing new costs without new funding on public or para-public bodies, and to avoid creating any bias against having such organizations contract out part of their activities to the private sector.
- Businesses (particularly those not eligible for GST rebates) would benefit from the introduction of consolidated return rules, to avoid anomalies in the taxation of charges between companies in the same corporate group.

The GST: A Hard Sell

No one suggested that it would be easy to convince Canadians of the need to adopt a new, broadly based, more visible consumption tax. But the hurricane of protest from consumer, labor, small business, and other groups, the determined opposition of all provinces, and even a drawing back of support from elements of the business sector confirm that putting the tax across will be a daunting task indeed.

The negative reaction of taxpayers in general was predictable, although perhaps not at the vociferous level that it has now reached. The GST is a solution to a problem that most Canadians are unaware they have, and it replaces an invisible tax — the FST on a relatively few items — with a more visible levy on almost all purchases. The GST appears to be basically bad news for consumers, delivered long after the good news of the income tax cuts in stage one of tax reform. And, as a new tax

unfamiliar to North Americans, it was bound to introduce confusion and suspicion on the part of the public, as well as small business.

A Disguised Tax Increase

A good deal of the resentment over the GST proposal really derives from the fact that it is a massive tax increase — one of the largest tax hikes ever to be imposed on the Canadian public. The new GST is intended to raise much more revenue than the just-increased FST (perhaps $25.0 billion compared with $18.5 billion). The additional revenue will go not to reduce the deficit but to cover the low-income refundable credits, the subsidy to new home buyers, a payment to small business to cover the costs of administering the tax, increased costs to the government caused by the GST, and a 1 percent cut in the middle personal income tax bracket (see Box 5). Treating all of these items, except for the income tax rate reduction, as expenditures means that the GST will raise total government revenues by something in the order of $6 billion a year. In the short term, the package is said to be revenue neutral: in the longer term, it would provide some contribution to deficit reduction as well as moving the total tax mix slightly toward consumption taxes and away from income taxes.

The GST package also involves a significant income redistribution, largely favoring Canadians with low incomes at the expense of middle-income consumers. This is because the GST credits, available only at the bottom of the income scale, are in excess of the estimated increase in the GST over the present FST borne by this group. Critics of sales taxes in general, and the VAT in particular, have frequently claimed that such taxes are regressive. But more thoughtful analysis shows that consumption taxes are not really particularly regressive when their incidence is measured over consumers' lifetimes, rather than annually. And the low-income credits and middle-income tax cuts that are part of the GST package seem adequate to eliminate the perceived annual regressivity.

Consumer Prices and the Economy

The GST clearly would raise consumer prices, although the exact impact is hard to predict. The 9 percent GST will replace the present 13 1/2 percent FST, which is levied generally at the wholesale level on only a fraction of retail prices, and only on a relatively narrow range of goods. The effect of the 9 percent GST will be to increase the price of something over two-thirds of consumer spending by 9 percent, less the reduction in the basic price of goods caused by the removal of the existing FST.

Given that the new tax is intended to raise some $6 billion more revenue than the FST it replaces, there clearly will be some net increase in aggregate consumer prices even under the best assumptions. The federal government estimates this increase at 2 1/4 percent; other forecasters suggest a somewhat higher jump. This more pessimistic view could prove to be correct, at least in the transitional phase, if prices prove to be "sticky", and producers do not pass on, through lower prices, the removal of the FST on the selling price of their goods as well as on their inputs. In many industries, competition will force down prices, at least over time, to reflect the removal of the FST, but there are infinite possibilities for confusion and resistance to appropriate price reductions.

The issue of how much the GST would raise prices in the short term — the GST price spike — is one of the biggest issues in considering the merits of the proposals. There is widespread concern that the GST price spike could be much larger than the government estimates, leading to a possible price/wage spiral, tighter money, and higher interest rates — although the Bank of Canada has indicated it would facilitate short-term adjustments to the GST — and adverse short-term effects on employment. (These concerns would, of course, be reduced if the GST rate were lowered to, say, 7 percent.)

The government argues that experience abroad indicates that the introduction of a VAT

Box 5

Fiscal Impact of the Goods and Services Tax

	1991
GST revenues	$25.0 billion
MST revenues lost	18.5
Excess	*$6.5 billion*

Excess represents additional tax extracted from the economy, used as follows:

Enhanced GST credits for individuals	$2.4 billion
Middle-income bracket personal tax cut	0.7
Price impact to federal government (indexing, transfers)	2.0
Administration	0.2
Housing subsidies	0.9
Rebate to small business for handling (est.)	0.3
Total	*$6.5 billion*

The relatively high GST rate, 9 percent, means transitional problems plus increased opposition:

- higher increase in the Consumer Price Index;
- greater likelihood of a price/wage spiral;
- possible serious economic transition effects, leading to temporarily lower GDP;
- more consumer resentment;
- a shift from income tax to consumption tax, resulting in transition problems.

In the long term, the GST, even without a rate increase, would provide extra revenues that could possibly be used to reduce the federal government's deficit.

Offsets

- cut the federal personal tax rate on the middle-income bracket from 26 to 25 percent; the maximum tax saving for an individual would be $468;
- increase the refundable sales tax credit for individuals to $275 for adults and $100 for children; introduce a clawback for individuals with taxable incomes in excess of $25,000;
- introduce a subsidy of up to $13,950 on new home purchases (which would not be sufficient, however, to cover increased tax on expensive homes or in high-price areas such as Toronto); claw back this subsidy on higher-priced homes.

is unlikely to raise consumer prices by much more than the net additional revenues collected — the flow-through assumption in the government's calculation. Critics argue that the GST is being introduced without enough offsetting sweeteners to keep labor happy, and in an economy where sticky prices may not fully reflect the repeal of the FST. The argument rages on: the sensible view may be that while the price spike could well be somewhat more than the government predicts, it is unlikely to be as high as some critics' worst-case scenarios.

The removal of the FST and the introduction of a GST will cause changes in relative tax-included prices. The most important effect will be a reduction in the net cost of goods purchased by producers, distributors, and

retailers, since the tax content of such purchases will now be rebated: the aggregate relief to Canadian business from this source has been estimated to be as much as $7 billion a year. This is a "first-order" effect only: clearly, the bulk of this will flow through in lower prices to consumers. But at the consumer level, too, there will be relative shifts in prices. The after-tax cost to consumers of many services and certain goods that would be subject to federal tax for the first time will clearly go up. There will be important shifts in relative prices even of goods previously subject to the FST. In the case of certain items, such as automobiles, where the present 13 1/2 percent FST is likely greater than a 9 percent tax on ultimate selling price, the after-tax cost may go down. But on goods with large markups after the manufacturers' gate, such as toys and cosmetics, the tax-inclusive price likely will rise. When the dust settles, however, the results will be a more even handed application of federal sales tax to most goods and services and, therefore, a net benefit through an increase in consumer sovereignty. (See Box 6 for potential winners and losers.)

Regardless of disagreement on the short-term effects of the GST, or confusion as to its implications for particular industries, economists are in widespread agreement that the long-term effects of the GST will be beneficial. The more efficient, less price-distorting, and internationally competitive GST would enable Canada to increase capital investment, output, and employment.

A Disarray of Opposition

Small Business

The application of the GST at the retail level, along with existing retail sales taxes in nine provinces, results in double calculation, a double tax administrative burden, and multiple confusion to retailers. It also gives rise, not unjustifiably, to a deep feeling of resentment by Canadians to such an obvious illustration of the inability of the federal and provincial governments to cooperate for the benefit of the country. And it is this combination of separate federal and provincial sales taxes — a situation that does not exist in other countries with a VAT — with its attendant complexity that is at the heart of the opposition by small business.

The skeleton in the closet is the details of the discussions between the federal and provincial governments about a joint, or national, sales tax. The public deserves a clearer understanding of the proposals that the federal government put forward in this area, and the reasons why the provinces chose not to opt in. A joint federal-provincial goods and services tax would be an infinite improvement, both economically and administratively, over the administrative mish-mash of a federal GST along with provincial retail sales taxes: the proposed federal-only GST is clearly a second-best solution.

Consumers

The proposed GST follows three years of massive tax hikes at the federal, provincial, and municipal levels. While it is difficult to measure, there are some arguments that Canada's tax burden has gone up more rapidly, in relative terms, than that of most other developed countries over this period. The GST — at the suggested 9 percent rate — represents a substantial further increase in taxes over the revenues from the present FST in order to pay for the GST offsets. The result is that the GST not only induces the inevitable opposition generated by any new tax, but also serves as a lightning rod for the resentment of taxpayers to higher taxes generally. The GST has become the symbol around which a rapidly gathering cloud of taxpayer irritation and resentment about all taxes is coalescing.

The introduction of a GST will strain the credibility and persuasive powers of the federal government, particularly since the tax is not well understood. Such a major shift in taxation requires a sustained effort to explain and clarify the tax to Canadians. The relatively

Box 6

Likely Economic Impact of the Goods and Services Tax

Winners

- Exporters
- Most manufacturers, producers (due to tax-free inputs)
- Manufacturers of many business supplies and goods for business (now effectively tax-free), including developers of industrial and commercial buildings
- Resource industries
- Producers of goods, services, where FST>GST (autos, etc.)
- Business in general; especially new firms and projects
- Low-income families (because of overcompensation for the GST)

Losers

- Importers
- Producers of services to consumers (and to certain purchasers such as financial, health industries)
- Manufacturers and retailers of goods previously exempt but now taxable (clothes, footwear, etc.)
- Producers of goods and services where GST>FST (high-margin products, luxury goods)
- Consumers in general, in the short term

smooth reception of a new VAT in New Zealand — that country's government conducted an enormous, 18-month education program before introducing a 10 percent VAT on all goods and services, including food — shows that such explanations can soften an otherwise difficult blow. Of course, New Zealand also had the foresight to introduce its VAT at the same time as it put through massive cuts in personal income taxes. The failure of the disaster-prone Japanese government to explain adequately a limited new 3 percent VAT, with resulting consumer confusion and anger, provides a sharp contrast. To date, the Canadian government has not given a clear indication that it understands the need to explain the GST to the public, other than through a few ill-starred newspaper ads.

The Provinces

The provinces have also lined up in loud and active opposition to the tax. While they have been less than totally articulate in their opposition, their main concerns seem to revolve around the fear that the GST will drive up prices significantly, thereby damaging the economy in the transitional years as well as increasing provincial costs and transfer payments and forcing the provinces to raise their own taxes. They also appear to resent federal intrusion into taxation at the retail level. Some of the calculations done in support of the provincial position seem to be based on extreme, worst-case scenarios, tinged with the usual provincial paranoia about new federal initiatives.

Labor

The labor movement has also condemned the GST and the government's apparent assumption that wage costs would not rise to recover fully the GST-induced spike in the cost of living. But labor demands for wage boosts to cover the GST price increase ignore the major offsets provided through low-income credits and personal tax cuts.

No Consensus

The federal GST initiative has gathered some support from business groups generally and from economists (although a number of the latter are concerned about the transitional effects). But perhaps the principal strategic advantage that the federal government retains

is the fact that the GST's opponents are united on only one thing — they don't like the tax. Opponents are largely divided as to why they are opposed, and almost totally silent in suggesting any alternative. While it is early days yet in the GST donnybrook, there may just be a hint that the opposition has peaked.

The Seven Percent Solution

The GST is the right solution for Canada, but unfortunately it has been delivered at the wrong time — divorced from the stage one personal tax cuts — and with some major excess baggage.

In addition to some inevitable rough edges, the primary problem with the proposed GST is its 9 percent rate. This relatively high rate, and its accompanying major increase in overall tax burdens, has given rise to understandable taxpayer resentment. Further, the introduction of a GST at a 9 percent rate will put significant short-term strain on the Canadian economy, with the resulting blip in prices giving rise to inflationary forces, possibly unleashing a wage/price spiral, and unfortunate monetary reactions. The options open to the government are not easy or clear: the GST must be introduced with some low-income credits in order to offset its regressivity, and should provide revenues to cover these and the replaced FST.

A number of critics have suggested that if the rate were brought down to, say, 7 percent, the larger part of the negative transitional effects might be avoided, and the longer-term beneficial effects would be apparent much sooner. The House of Commons Finance Committee, under the chairmanship of Don Blenkarn, appears ready to suggest a 7 percent rate, financed by some clawback in offsets and possibly some extension of the tax. However it is arranged, a cut in the GST rate from 9 to 7 percent would mean a net reduction of almost $6 billion a year in tax revenue, and it is not easy to see how this revenue loss could be entirely made up in the short term. To finance such a reduction, there clearly could and should be some shaving of the low-income credits (which need not be as large with a lower rate), and quite possibly the elimination of the middle-bracket income tax reduction. However, even these modest changes — not sufficient in themselves to make up for the revenue loss — involve important policy tradeoffs: cutting out the personal tax reduction means shifting more of the burden to the middle class. (In terms of rate reduction, extending the tax to basic foodstuffs would enable the rate to be cut from 9 to 8 percent, and might make the tax fairer and easier to administer: however, this change would do nothing to ease the tax's impact on the aggregate price level.)

There is no doubt that an initial 7 percent rate would make the tax more acceptable politically and reduce the concern about its negative short-term effects. The odds are likely against getting the rate as low as 7 percent, however, without some short-term adverse effect on the federal deficit or the imposition of some additional taxes. The situation simply confirms the old tax policy adage that it is difficult to implement fundamental reforms in a system without fiscal maneuvering room to help solve the inevitable resistance: Canada's intractable budget deficits make the transition to a reformed sales tax structure much more difficult than would otherwise be the case.

Conclusion

It is important to recognize that the GST is a very substantial improvement over the present FST, and represents an enormous advance in the efficiency and, ultimately, the revenue capacity of the federal tax system. The long-term economic advantages that could flow from the adoption of a GST (along with a related reform of provincial retail sales taxes) may be larger, in the aggregate, than those that are anticipated to flow from the free trade agreement between Canada and the United States.

The issue is not whether Canadians would enjoy paying the GST, or even whether it is a "good" tax. Rather, the question is whether

there is any alternative mechanism to raise over $20 billion in revenue without more adverse effects on the Canadian economy and its international competitiveness. To date, no such better alternative has emerged.

International trends toward a global economy and global capital markets require Canada to re-evaluate its taxation structure in the light of the new imperatives to maintain international competitiveness. The adoption of a fundamentally reformed sales tax structure would be a vital first step toward recognizing this imperative.

The government has only a short window of opportunity in which to implement the GST. The conventional wisdom seems to be that any government implementing a VAT would want to do so at least two years in advance of the next election so as to allow time for consumer resentment and confusion to die down. If the GST is to go into effect as planned on January 1, 1991, the debate must end and the bill be passed by Parliament by next March or April. If the tax is derailed for any significant period, it is likely to disappear from the agenda of this and even subsequent governments, and Canadians may have to wait decades for a similar structural improvement. Overall, the adoption of a GST would be the single most significant recent advance in Canadian tax policy, adding substantially to the country's economic efficiency: it is worth the effort to get it right, and to get it adopted.

Notes

1. Royal Commission on the Economic Union and Development Prospects for Canada [Macdonald Commission], *Report*, 3 v, (Ottawa: Supply and Services Canada, 1985); and Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation*, Report of a Committee chaired by J.E. Meade (London: George Allen & Unwin, 1978).

   Consumption taxation, unlike income taxation, does not distort savings. An income tax, by taxing the returns to saving, raises the "price" of future consumption relative to present consumption, and thus favors the latter. Under a consumption tax, present and future consumption bear the same rate of tax. Replacement of the income tax by a consumption tax would also result in an increase in the labor supply and in the rate of return on investment. It would appear then that the move from an income-based tax to a consumption-based tax could result in substantial efficiency gains and a major boost to GNP (Macdonald Commission, *Report*, v. 2, p. 207).

2. Switzerland has a complex wholesale tax, imposed partly at the wholesale level and partly at the retail level: the Swiss believe that this tax, too, is in urgent need of reform.

3. See Economic Council of Canada, *Road Map for Tax Reform* (Ottawa: Supply and Services Canada, 1987), pp. 8, 15–16, 18.

4. Department of Finance, *Guidelines for Tax Reform in Canada* (Ottawa, October 1986).

5. There had been informal indications that at least some provinces were attracted to a VAT in concept, particularly as provincial retail sales taxes are also in urgent need of reform.

Fiscal Policy Monitor © is an occasional publication of the C.D. Howe Institute. Its purpose is to assess and comment on the spending, taxation, and borrowing activities of Canadian governments.

As with all Institute publications, the views expressed here are those of the author and do not necessary reflect the opinions of the Institute's members or Board of Directors.

Robert D. Brown is Vice-Chairman, Price Waterhouse, Toronto.

For further information, please contact: Barry A. Norris, Director of Publications, C.D. Howe Institute, 125 Adelaide Street East, Toronto, Ontario M5C 1L7 (telephone 416-865-1904; fax 416-865-1866).

All Institute publications can be ordered from: Renouf Publishing Company Limited, 1294 Algoma Road, Ottawa, Ontario K1B 3W8 (telephone: 613-741-4333; fax: 613-741-5439), or from Renouf's stores at 61 Sparks Street Ottawa, Ontario (telephone: 613-238-8985) and 211 Yonge Street, Toronto, Ontario (telephone: 416-363-3171).

Quotation with appropriate credit is permissible. Single copies are available at $5.00 each.

ISBN 0-88806-251-6

Recent C.D. Howe Institute Publications

Lipset, Seymour Martin. *Continental Divide: The Values and Institutions of the United States and Canada*, CAC 59 (October 1989). ISBN 0-88806-240-0. 326 pp.; $15.00.

Farrow, Maureen, and Robson, William B.P. *The Long Road Back to Balance: Federal Fiscal Policy Following the April 1989 Budget*, Fiscal Policy Monitor 2 (July 1989). ISBN 0-88806-247-8. 16 pp.; $5.00.

Rugman, Alan M., and Anderson, Andrew. *How to Make the Free Trade Agreement Work: Implementing the Dispute Settlement Measures and the Subsidies Code*, Trade Monitor 11 (July 1989). ISBN 0-88806-246-X. 12 pp.; $5.00.

Popov, Vladimir V. *Perestroika: An Insider's View*, Trade Monitor 10 (July 1989). ISBN 0-88806-249-4. 12 pp.; $5.00.

Gilson, J.C. *World Agricultural Changes: Implications for Canada*, Policy Study 7 (June 1989). ISBN 0-88806-233-8. 219 pp.; $15.00.

Farrow, Maureen, and Robson, William B.P. *Building a Constituency for Deficit Reduction*, Fiscal Policy Monitor 1 (April 1989). ISBN 0-88806-248-6. 16 pp.; $5.00.

Carmichael, Edward A., Macmillan, Katie, and York, Robert C. *Ottawa's Next Agenda*, Policy Review and Outlook, 1989 (February 1989). ISBN 0-88806-239-7. 175 pp.; $15.00.

Golt, Sidney. *The GATT Negotiations, 1986–90: Origins, Issues and Prospects*, BNAC 36 (December 1988). ISBN 0-902594-48-6. 106 pp.; $15.00.

Gilson, J.C. *The GATT Midterm Review and Agriculture: Prospects for Trade Reform in the Uruguay Round*, Trade Monitor 9 (November 1988). ISBN 0-88806-242-7. 12 pp., $5.00.

Hampson, H. Anthony. *Nikka Kankei: Japanese-Canadian Relations, the Opportunities Ahead*, Observation 33 (November 1988). ISBN 0-88806-244-3. 91 pp.; $10.00.

Lipsey, Richard G. *The Free Trade Deal and Canada's Sovereignty: Are the Fears Justified?*, Trade Monitor 8 (November 1988). ISBN 0-88806-232-X. 12 pp.; $5.00.

Lipsey, Richard G. and York, Robert C. *The Free Trade Deal: Shall We Forsake the Bird in the Hand?*, Trade Monitor 7 (October 1988). ISBN 0-888-6-241-9. 8 pp.; $5.00.

Horlick, Gary N., Valentine, Debra A., and Steger, Debra P. *Two Views on Dispute Settlement and Trade Laws in the Canada-U.S. Free Trade Agreement*, Trade Monitor 6 (October 1988). ISBN 0-88806-229-X. 12 pp., $5.00.

Lipsey, Richard G., and York, Robert C. *Evaluating the Free Trade Deal: A Guided Tour through the Canada-U.S. Agreement*, Policy Study 6 (July 1988). ISBN 0-88806-228-1. 139 pp.; $14.95.

Allen, Kristen, and Macmillan, Katie (eds.). *U.S.-Canadian Agricultural Trade Challenges: Developing Common Approaches* (July 1988). ISBN 0-915707-44-6. 218 pp.; $15.00.

Farrow, Maureen. *The Toronto Economic Summit: Great Expectations Need to Be Tempered by Realism*, C.D. Howe Institute Commentary 16 (June 1988). ISBN 0-88806-236-2. 8 pp.; $5.00.

British-North American Committee. *New Departures in Industrial Relations: Developments in the U.S., the U.K. and Canada*, BNAC Occasional Paper 5 (June 1988). ISBN 0-89068-092-2. 74 pp.; $10.00.

Farrow, Maureen, and Rugman, Alan A. (eds.). *Business Strategies and Free Trade: Focus on Corporate Adjustment*, Policy Study 5 (May 1988). ISBN 0-88806-231-1. 99 pp.; $15.00.

Carmichael, Edward A. (ed.). *Tax Reform: Perspectives on the White Paper*, Policy Study 4 (February 1988). ISBN 0-88806-177-3. 108 pp.; $15.00.

Carmichael, Edward A., and Macmillan, Katie. *Focus on Follow-through*, Policy Review and Outlook, 1988 (February 1988). ISBN 0-88806-176-5. 104 pp.; $15.00.